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IN THE

Supreme Court of the United States

October Term, 1940

No. 400.

In the Matter of
CONSOLIDATED ROCK PRODUCTS CO., a Delaware corporation,
Debtor,

UNION ROCK COMPANY, a corporation,
Subsidiary,

and

CONSUMERS ROCK & GRAVEL COMPANY, INC., a corporation,
Subsidiary.

CONSOLIDATED ROCK PRODUCTS CO., a corporation, and EDWARD E. HATCH and LOUIS VAN GELDER, composing the Preferred Stockholders Committee of Consolidated Rock Products Co.,
Petitioners,

vs.

E. BLOIS DU BOIS,
Respondent.

BRIEF FOR THE PETITIONERS.

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BRIEF FOR THE PETITIONERS.

Opinions Below.

The opinion of the District Court was filed September 8, 1938 and is not yet reported but appears in the transcript at page 231. The first opinion of the Circuit Court of Appeals affirming the trial court was filed November 4, 1939 and reported in 107 Fed. (2d) 96, Advance Sheets. The second opinion of the Circuit Court of Appeals reversing its earlier opinion was filed June 19, 1940 and is reported at 114 Fed. (2d) 102, Advance Sheets. The order denying petitioner's petition for rehearing was entered on the 5th day of August, 1940.

Jurisdiction.

The final judgment of the Circuit Court of Appeals was filed on June 19, 1940; a petition for rehearing was filed in the Circuit Court on July 19, 1940 and denied on August 5, 1940. A petition for a writ of certiorari was filed September 6, 1940 and was granted October 28, 1940. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Statute Involved.

The statute here involved is Section 77B of the Bankruptcy Act, 48 Stat. 912 (1934), 11 U.S.C.A. §207 (1937).

Statement.

Throughout this brief we may, for brevity, refer to certain names as follows: Consolidated Rock Products Co., a Delaware corporation, as Consolidated; Consumers Rock & Gravel Company, Inc., a Delaware corporation, as Consumers; Union Rock Company, a Delaware corporation, as Union; the case of *Case v. Los Angeles Lumber Products Co., Limited*, 308 U. S. 106 (1939), as the *Lumber Company* decision; and the Securities & Exchange Commission as the S.E.C.

The facts in this case are set forth at length in our Petition for a Writ of Certiorari, pages 3 to 9, inclusive.

They are also set forth in the opinions of the court below. Summarized, they are as follows:

1. Union and Consumers are wholly owned subsidiaries of Consolidated and are being reorganized with it as subsidiaries. [R. 219.]

2. Union and Consumers had outstanding bond issues at the time their capital stock was acquired by Consolidated. Reliance had no bonded debt. [R. 235.]

3. Consolidated has had no bonded debt at any time, its financial structure consisting of preferred and common stock only. [R. 234.]

4. Consolidated has never assumed the bonded indebtedness of Union or Consumers. [R. 235.]

5. The only possible liability of Consolidated to Union or Consumers—not the bondholders—arises out of an operating agreement entered into in 1929.

(a) Said operating agreement provides that it is for the mutual benefit of the parties to it, i.e., Consolidated, Union, Consumers and Reliance, respectively and not for the benefit of any third party. [R. 237.]

(b) The operating agreement was modified by an agreement of February 19, 1933, providing for

I. A method of determining depreciation on a fair basis rather than book value at the time of acquisition, and

II. A method of liquidating any sum which might be due thereunder. [R. 179, 237.]

6. Pursuant to the operating agreement, Consolidated has operated all the properties as a unit since

April 1, 1929. From that date to the date of filing of the petition for reorganization under 77B, Consolidated paid the interest and sinking fund requirements on Union and Consumers bonds as follows:[1]

	Interest paid	Sinking fund payments	Total
Union bonds	$603,240.00[2]	$443,500.00[4]	$1,046,740.00
Consumers bonds	412,305.00[3]	299,500.00[5]	711,805.00
Total	$1,015,545.00	$743,000.00	$1,758,545.00

7. On May 24, 1935, Consolidated, Consumers and Union filed petitions for reorganization under 77B. [R. 26.]

8. After several years of bitter bickering and threats of litigation, the interested parties agreed upon a plan of reorganization providing essentially for the following:

(a) A new corporation to which all the assets of Consolidated and its subsidaries will be transferred.

(b) The bondholders of Union and Consumers will surrender their bonds, cancel accrued interest to April 1, 1937, and receive in lieu of each such bond a new bond with 5% cumulative interest in one-half the principal amount of the original bond; new preferred stock of a par and preference value equal to one-half of the principal amount of the original bond and common stock purchase warrants.

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[1]R. 185-188.
[2]default Mar. 1, 1934.
[3]default July 1, 1934.
[4]default Sept. 1, 1933.
[5]default July 1, 1934.

(c) The new bonds and the new preferred stock will be issued by the new corporation and will constitute a lien and a preference respectively against all of the assets of the new corporation.

(d) The old preferred stockholders of Consolidated will receive one share of common stock of the new corporation for each share of old preferred stock.

(e) The old common stockholders of Consolidated will receive stock purchase warrants entitling them for a limited time to purchase for cash one share of new common stock for each five shares of old common owned.

(f) Consolidated will surrender for cancellation $166,000. par value of Union and Consumers' bonds and will transfer all of its assets to the new corporation to become subject to the aforesaid lien and preference of the Union and Consumers bondholders.

(g) The new corporation shall have nine directors, of whom the present bondholders shall elect four, except that when a default exists respecting bond interest, the present bondholders shall elect six directors.

(h) There are no other interested parties dealt with, current creditors having been taken care of currently. [R. 26-31, 49-50.]

9. Requisite consents were filed in the proceeding by all interested parties including the bondholders of Union and Consumers. [R. 260.]

10. Extended hearings on the plan were held before a special master; extended hearings were held

before the District Court on the special master's report recommending confirmation; and then the plan was finally confirmed.

11. An appeal was taken by one objector who acquired his bonds after default and just before and after the commencement of the 77B proceedings at an average cost of fifteen cents on the dollar. [R. 156-7.]

12. The Circuit Court of Appeals affirmed the decree of the District Court.

13. Subsequently, the Circuit Court of Appeals reversed itself and the District Court as a result of the *Lumber Company* case.

14. The basis for the Circuit Court of Appeals' reversal of itself and of the trial court was:

a. Before it can be determined whether or not from the standpoint of preferred stockholder participation the plan is fair and equitable within the standard set up by the *Lumber Company* case, there must first be:

1. A settlement voluntarily or by litigation of the claim of Consumers and Union against Consolidated arising out of the operating agreement, and

2. A precise finding of the value of the properties.

b. The plan is not fair and equitable within the test set up by the *Lumber Company* case because the preferred stockholders are given an interest in the separate properties of Consumers and Union.

c. The plan is not fair and equitable within the test set up by the *Lumber Company* case because the bondholders of Union are given an interest in the separate property of Consumers and the bondholders of Consumers are given an interest in the separate property of Union.

Specification of Errors.

I. THE CIRCUIT COURT ERRED IN RULING THAT THERE MUST BE A SETTLEMENT OF THE DISPUTED CLAIM ARISING FROM THE OPERATING AGREEMENT BEFORE THIS PLAN CAN BE DETERMINED TO BE FAIR AND EQUITABLE FROM A STANDPOINT OF PREFERRED STOCKHOLDER PARTICIPATION.

II. THE CIRCUIT COURT ERRED IN RULING THAT THERE MUST BE A PRECISE FINDING OF VALUE BEFORE THIS PLAN CAN BE DETERMINED TO BE FAIR AND EQUITABLE FROM THE STANDPOINT OF PREFERRED STOCKHOLDER PARTICIPATION.

III. THE CIRCUIT COURT ERRED IN FINDING THE PLAN NOT FAIR AND EQUITABLE BECAUSE THE PREFERRED STOCKHOLDERS ARE THEREBY GIVEN AN INTEREST IN THE SEPARATE PROPERTIES OF CONSUMERS AND UNION.

IV. TRE CIRCUIT COURT ERRED IN FINDING THE PLAN NOT FAIR AND EQUITABLE BECAUSE THE BONDHOLDERS OF UNION ARE THEREBY GIVEN AN INTEREST IN THE SEPARATE PROPERTY OF CONSUMERS AND THE BONDHOLDERS OF CONSUMERS ARE THEREBY GIVEN AN INTEREST IN THE SEPARATE PROPERTY OF UNION.

V. THE CIRCUIT COURT ERRED IN FAILING TO FIND THE PLAN FAIR AND EQUITABLE IN ALL RESPECTS.

ARGUMENT.

I. A SETTLEMENT BY AGREEMENT OR OTHERWISE IS NOT NECESSARY IN ORDER THAT THIS PLAN MAY BE DETERMINED TO BE FAIR AND EQUITABLE FROM THE STANDPOINT OF PREFERRED STOCKHOLDER PARTICIPATION.

(a) The Circuit Court erroneously applied the *Lumber Company* case in ruling *as a matter of law* that the plan cannot be determined to be fair and equitable until there is a settlement of the disputed claim

(b) Even assuming that the propriety of the compromise in the present case *is a question of fact*, the Circuit Court erred in reversing the determination of the District Court that it was proper for the parties to compromise the disputed claim and embody the compromise in the reorganization plan.

II. A MORE PRECISE FINDING OF VALUE IS NOT NECESSARY IN ORDER THAT THIS PLAN MAY BE DETERMINED TO BE FAIR AND EQUITABLE FROM THE STANDPOINT OF PREFERRED STOCKHOLDER PARTICIPATION.

(a) The Circuit Court erroneously applied the *Lumber Company* case in ruling *as a matter of law* that the plan cannot be determined to be fair and equitable without more precise findings of value.

(b) Even assuming that the preciseness of findings of value *is a question of fact*, the Circuit Court erred in reversing the determination of the District Court that the present findings of value are sufficient.

III. THE PLAN IS FAIR AND EQUITABLE IN GIVING THE PREFERRED STOCKHOLDERS AN INTEREST IN ALL ASSETS OF THE NEW CORPORATION INCLUDING THE ASSETS OF UNION AND CONSUMERS.

IV. THE PLAN IS FAIR AND EQUITABLE IN GIVING THE BONDHOLDERS OF UNION AND CONSUMERS AN INTEREST IN THE PROPERTIES OF CONSUMERS AND UNION, RESPECTIVELY.

V. THE PLAN IS FAIR AND EQUITABLE.

We stated in our brief on petition for certiorari and repeat here that the lower court did not analyze the factual situation in the case at bar. In that brief, we sought to analyze the facts and compare them with those in the Lumber Company decision. Because of the importance of the facts in this case, we have for the convenience of the Court attached that fact comparison as Appendix No. I.

I.

A Settlement by Agreement or Otherwise Is Not Necessary in Order That This Plan May Be Determined to Be Fair and Equitable From the Standpoint of Preferred Stockholder Participation.

(a) THE CIRCUIT COURT ERRONEOUSLY APPLIED THE LUMBER COMPANY CASE IN RULING AS A MATTER OF LAW THAT THE PLAN CANNOT BE DETERMINED TO BE FAIR AND EQUITABLE UNTIL THERE IS A SETTLEMENT OF THE DISPUTED CLAIM.

At no place in the *Lumber Company* decision is there any intimation that compromises of disputed claims are not permissible in a 77B reorganization. Rather, this Court seems to have taken the opposite and only reasonable position that compromises are often not only permissible but desirable. There it said, after pointing out that a groundless threat of litigation did not justify giving an interest to stockholders:

> "Of course, this is not to intimate that compromise of claims is not allowable under section 77B. There frequently will be situations involving conflicting claims to specific assets which may, in the discretion of the court, be more wisely settled by compromise rather than by litigation. . . . In sanctioning such settlements the court is not bowing to nuisance claims, it is administering the proceedings in an economical and practical manner." (p. 130.)

This court then cited with approval *In the Matter of Detroit International Bridge Co. Debtor,* Corporate Reorganization Release No. 9, 30 F. Supp. 127 (U.S.D.C. E.D. Mich., 1939). There the claims of the senior creditors far exceeded the value of the properties. Yet the

plan gave to the junior creditors 7.7% of the equity of the new corporation. One of the reasons given for their participation was:

> "(3) By reason of the fact that the Michigan property taxes were unpaid during the pendency of the tax controversy, a substantial amount of cash was on hand when the petition to reorganize was filed on May 26, 1938. The representatives of the debenture holders asserted a claim to a proportionate share of this cash. This claim, if valid, would mean that the debenture holders would be entitled to be paid perhaps as much as $220,000 in cash. The representatives of the bondholders stated that, without conceding the validity of the claim, they deemed it sufficient to warrant adjustment by way of settlement."[1]

The S. E. C. in its report approved the plan as fair and equitable from the standpoint of the participation by the junior creditors for the reason above set forth. It did not even suggest that the judgment of the bondholders, that such a compromise was desirable, should be inquired into, but rather it abided by their judgment without even discussing the merits of the claim of the junior creditors.

The purpose of 77B and its successor, Chapter X,[2] is to present a procedure for the expeditious reorganization of corporations in a manner that will preserve to the security-holders the value of the enterprise as a going enterprise. In such reorganizations there are always a number of conflicting interests making adverse claims the settlement of

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[1] *In the Matter of Detroit International Bridge Company*, S.E.C. Corporate Reorganization Release No. 9, p. 6 (Mar. 24, 1939).

[2] 52 Stat. 883 *et seq.* (1938), 11 U.S.C.A. §502 *et seq.* (1939).

which would be both expensive and time-consuming. To effectuate the purpose and intent of the statute, compromises of reasonably disputed claims must be allowed.

Prior to the decision in the *Lumber Company* case, the Circuit Court here had affirmed the decree of the District Court approving the present plan.[1] It necessarily must have agreed with the District Court that this same plan, embodying the same compromise, was fair and equitable. Then following the *Lumber Company* decision, the Circuit Court reversed its prior decision in part upon the ruling that the compromise cannot be sanctioned. This, it did without any consideration whatever of the merits of the compromise. It merely ruled that any compromise of this dispute could not be sanctioned. Such a ruling must be a rule of law mistakenly based upon the *Lumber Company* case, and as such it is clearly wrong and should be reversed.

(b) Even Assuming That the Propriety of the Compromise in the Present Case Is a Question of Fact, the Circuit Court Erred in Reversing the Determination of the District Court That It Was Proper for the Parties to Compromise the Disputed Claim and to Embody the Compromise in the Reorganization Plan.

The dispute here centers around the effectiveness of the agreement of February 1933, modifying the original operating agreement. In 1929 all the corporations entered into the original operating agreement which provided, among other things, that Consolidated should depreciate, deplete and amortize the operating properties according to proper accounting methods, but did not, however, spe-

[1] 107 Fed. (2d) 96, Advance Sheets.

cify the basis for such depreciation, etc.; that upon the termination of the agreement there should be a final accounting and settlement, and that the agreement could be terminated by either Consolidated or the owning companies on 30 days notice. [R. 167-174.] Consolidated then began crediting the owning companies with depreciation, etc., based upon subsidiary book values of about 13.5 million. It was soon thereafter realized that these book values were grossly in excess of actual values. In 1933 all the corporations entered into a second agreement modifying the original agreement of 1929. This 1933 agreement definitely fixed the basis for depreciation, etc., as actual current values, and like the original agreement provided for an accounting and settlement at the termination of the agreement. It further provided for a definite term of 5 years with an option to Consolidated to extend the agreement another 5 years, and it gave Consolidated an option in making the settlement at the termination of the agreement to defer payments due thereunder over a 10 year period, paying 75% of the amount due at the end of the 10th year. [R. 178-181.] Thus, by the terms of the modified operating agreement, Consolidated could extend the agreement to 1943, and could then defer the payment of 75% ~~of any~~ amount due until 1953.

The Record shows that in formulating the plan, the representatives of the bondholders were fully aware of the possibility of rights in the bondholders against the assets of Consolidated arising from the operating agreement. [R. 275-6, 278.] The Record further shows how all the interested parties were very hostile to each other and that they were unwilling to give one bit more than was absolutely necessary. [R. 147.] When the representatives of the bondholders and the preferred stock-

holders finally agreed upon the present plan, the approval of the distribution of the securities therein provided for necessarily involved a compromise of the disputed claim arising out of the operating agreement. The approval by the District Court of the plan and the distribution of securities therein provided for likewise necessarily involved an approval of the compromise. All interested parties except this lone objector have either agreed to the compromise or have acquiesced in its approval. Now at the instance of this lone objector the Circuit Court has ruled that the compromise cannot be sanctioned, but in effect, that the claim must be settled by litigation before it can be determined whether or not the plan is fair and equitable.

An analysis of the merits of the contentions of the parties will show that the decision of the District Court on this question was the only decision reasonably possible.

The contention of the objecting bondholder is that the agreement of 1933 is void and that Consumers and Union have a present claim against Consolidated based upon the original agreement, which claim may be reached by the bondholders. On the other hand, the preferred stockholders take the position that the agreement of 1933 is neither void nor voidable, that any rights must be determined by the agreement *as modified,* and that, at most, the rightful claim of Consumers and Union is for an indefinite amount, the payment of which, when determined, Consolidated could properly defer, for the most part, until 1953.

The validity of contracts entered into by the debtor is governed by State law.

See *Benedict v. Ratner,* 268 U. S. 353, 359, 45 S. Ct. 566, 567 (1925);

2 *Gerdes on Corporate Reorganization* (1st Ed. 1939), Section 883;

4 *Remington on Bankruptcy* (4th Ed. 1935), Section 1406.

Since the operating agreement and the modification thereof were executed and were to be performed in California, the California law governs.

Restatement, Conflict of Law (1934), Section 332(e).

By California law the agreement of 1933 is valid. It is neither void nor voidable, because the contracting corporations had common officers and some common directors.

Buck v. Tuxedo Land Co., 109 Cal. App. 453, 293 Pac. 122 (1930).

(held: that a transaction between two corporations having identical boards of directors cannot be avoided by a minority stockholder without an affirmative showing of fraud or injury. Dictum at p. 461, Pac. 125, that if ratified by a majority of stockholders, the minority stockholder could avoid it only upon proof of fraud. This case very thoroughly discusses the California cases on this question.)

6 *California Jurisprudence* (1926), Section 449.

While this law relates to a minority stockholder, certainly a creditor stands in no better position.

The agreement of 1933 is neither void nor voidable for fraud. Certainly there is nothing in the record that

even remotely suggests fraud. As a matter of fact, all of the equities support the modification. It places depreciation definitely on a fair basis instead of the basis of inflated subsidiary book values. There is no other basis upon which it can be contended that the agreement is void or voidable.

Furthermore, those rights which actually exist under the operating agreement are not direct rights of the bondholders. The agreement expressly stated that it was not made for the benefit of third persons. The rights of a mortgagee under a mortgage are governed by state law, just as are questions of the validity of contracts.

See *Humphrey v. Tatman,* 198 U. S. 91, 25 S. Ct. 567 (1905);

2 *Gerdes on Corporate Reorganizations* (1939), Section 883;

4 *Remington on Bankruptcy* (4th Ed. 1935), Section 1406.

Since the properties are located in California, California law governs.

Restatement, Conflict of Laws (1934), §225, 265.

By California law before the bondholders can assert any right to this claim of their corporations there must be a foreclosure sale and it must then be established by appraisers that the value of the properties subject to the bond indentures is less than the bond principal plus accrued interest.

Calif. Code Civ. Proc. (Deering, 1937), §726. [See Appendix II.]

From all of this, how can it be said that the preferred stockholders are unreasonable in denying the existence of any present liability under the operating agreement. Rather it seems that any unreasonableness lies on the side of the

espondent in asserting that a present liability exists. In uch a situation, to require *in the interests of the bond-olders* and at the instance of this sole objector that there e time-consuming and expensive litigation of this dis-oute is wholly beyond reason. Yet, that is precisely what he Circuit Court has done.

Here the bondholders have a very tenuous claim, the nost that can be said for it being that each side reason-bly disputes the claim of the other. The present plan mbodying a compromise of this claim was promulgated fter years of bitter fighting between the interests in-olved. All parties agree that it would be most unde-irable to jeopardize the possibility of ultimate unified peration of the properties. The interested parties, the pecial master and the District Court all, after extended nd careful consideration, have concluded that no other ettlement than that embodied in the plan is possible and hat litigation will wreck the whole enterprise.

If it was proper to compromise the disputed claim in he *International Bridge* Reorganization, *supra,* how can be said *in the interests of the bondholders* in the present ase that the disputed claim should be litigated. Certainly, ny litigation here will be much more expensive and time-onsuming than it would have been there. Here, not only e merits of the case but also the judgment of all of the terested parties point to the single conclusion that the ispute be compromised. Yet, in the face of all this, the ircuit Court, presumably acting *in the interests of the ondholders* but actually at the instance of this lone ob-ector who purchased his bonds at fifteen cents on the ollar, has in effect ruled that there must be a litigation f this disputed claim.

We respectfully submit that the ruling of the Circuit ourt was clearly unreasonable and should be reversed.

II.

A More Precise Finding of Value Is Not Necessary in Order That This Plan May Be Determined to Be Fair and Equitable From the Standpoint of Preferred Stockholder Participation.

(a) THE CIRCUIT COURT ERRONEOUSLY APPLIED THE LUMBER COMPANY CASE IN RULING AS A MATTER OF LAW THAT THE PLAN CANNOT BE DETERMINED TO BE FAIR AND EQUITABLE WITHOUT MORE PRECISE FINDINGS OF VALUE.

There certainly is nothing in the *Lumber Company* decision that even remotely suggests that in every 77B reorganization there must be a precise finding of value. True enough, the fair and equitable standard there set forth might be considered to require some collateral determination of value, but the proposition that in every 77B reorganization there must be a minute appraisal to ascertain the precise value of the properties involved finds no support whatever in this case.

Prior to the decision of the *Lumber Company* case, the Circuit Court here had affirmed the decree of the District Court approving the present plan.[1] It necessarily must have agreed with the District Court that this same plan based upon the present findings of value was fair and equitable. Then following the *Lumber Company* decision, the Circuit Court reversed its prior decision in part upon the ruling that there must be a more precise finding of

[1] 107 Fed. (2d) 96, Advance Sheets.

value. This, it did, without any consideration of the soundness of the present findings of value. It merely ruled that no findings of value, short of those ascertainable by a minute and detailed appraisal, will be sufficient. Such a ruling must have been a ruling of law mistakenly based upon the *Lumber Company* case, and as such it is clearly wrong and should be reversed.

(b) Even Assuming That the Preciseness of Findings of Value Is a Question of Fact, the Circuit Court Erred in Reversing the Determination of the District Court That the Present Findings of Value Are Sufficient.

The decision of the District Court was reached in the light of findings of value of the properties which were based upon the testimony of three independent and very capable witnesses, Gautier, Rogers and Mitchell. [R. 239.] It is striking how close their total valuations are. [R. 281-2, 290, 292.] The Record shows the long experience of these three witnesses in the rock business, and their familiarity with all of their properties. No one could be found in Southern California or elsewhere who has the intimate knowledge of this business in Southern California and the condition of these properties that each of these three men has. Mr. Mitchell has been an active officer of Union since its organization in 1922. Mr. Gautier was for many years prior to 1929 an active officer of Consumers. Both men have actively participated in the management of Consolidated since its organization in

1929. [R. 279, 290.] Mr. Rogers was employed by Union for many years before the organization of Consolidated in 1929, and since that time has been actively connected with a competing rock company. [R. 291-2.] Doubtless the District Court felt that the figures of Gautier, the former head of Consumers, might be high for Consumers' properties and low for Union. The converse was true regarding the figures of Rogers, one of the former heads of Union. Rogers was anything but a friendly witness. He was not called by the petitioners. Mitchell has always been neutral.

The District Court found that an appraisal would take a great deal of time, would be extremely difficult because of the physical commingling of the properties, would be very expensive and, when completed, would be of questionable accuracy. [R. 225.]

The Record shows that the preferred stockholders originally wanted an appraisal, but withdrew their request after considering the expense, delay and questionable value of an appraisal and the correlation of the testimony of Gautier, Rogers and Mitchell. [R. 271-2.] The Union committee at one time considered an appraisal, but later abandoned the idea for the same reasons. [R. 274-5.]

In the face of all this the Circuit Court has, in effect, ruled that there must be an expensive appraisal of all the properties.

Just as a determination by the District Court must be based upon an informed independent judgment, *National Surety Co. v. Coriell,* 289 U. S. 426, 53 S. Ct. 678 (1933),

so a determination by the Circuit Court must be based upon an informed and independent judgment. The present case is a very complicated case. The difficulties which would be faced in an attempt at an accurate appraisal; the extent to which, in the interests of unified operation the properties have been commingled; the expense required for such an appraisal and the benefit thereof, if any, can be fully appreciated by a court only after extended hearings, in which all interested parties present all sides of the question. We submit that the Circuit Court was not sufficiently informed to warrant its making a ruling on this very complicated question of fact.

Even assuming that the facts before the Circuit Court warranted a determination by it of the expense and time required and the results of an appraisal, it still remains clear: first, that any appraisal will be subjected to the same bickering that has characterized the past proceedings; second, that the properties have been commingled in the interests of unified operation to a point where such an appraisal would be very expensive and would only give rise to a false sense of accuracy; and third, that the question of appraisal does not arise in this case until the foreclosure of the mortgages securing the bond issues and the establishment of a deficiency thereunder. We submit that this ruling of the Circuit Court was, as to the present set of facts, clearly unreasonable and should be reversed.

III.

The Plan Is Fair and Equitable in Giving the Preferred Stockholders an Interest in All Assets of the New Corporation Including the Assets of Union and Consumers.

The Circuit Court has ruled, without regard to the extent of the contribution of assets by the preferred stockholders, that the plan is not fair and equitable because the stockholders thereby receive an interest in properties of Union and Consumers when those properties admittedly are not sufficient to pay bond principal and accrued interest. Where stockholders make no contribution of value to the new corporation, they obviously cannot be given any interest in properties that are insufficient to pay the claims of bondholders. This is the holding of the *Lumber Company* case. However, where the stockholders contribute assets of value to the new corporation, they must be given an interest in the corporation. This Court said in the *Lumber Company* case:

> "It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. This Court, as we have seen, indicated as much in Northern Pacific Railway Co. v. Boyd, *supra,* and Kansas City Terminal Ry. Co. v. Central Union Trust Co., *supra.* Especially in the latter case did this Court stress the necessity, at times, of seeking new money 'essential to the success of the undertaking' from the

old stockholders. Where that necessity exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made." (p. 121.)

In this case the preferred stockholders are making a contribution of assets to the new corporation and they are entitled to receive in return a participation reasonably equivalent to this contribution. Any participation must necessarily be a participation in all of the assets, including the assets contributed by the bondholders. If it is not fair and equitable to give these preferred stockholders an interest in all the assets of the new corporation by giving them junior securities in the new corporation, neither would it be fair and equitable to give securities in a new corporation to old stockholders of an insolvent corporation who had "made a fresh contribution." Such a proposition, following necessarily from the ruling of the Circuit Court, is obviously contrary to the statement of this Court just quoted. This ruling of the Circuit Court must be reversed.

IV.

The Plan Is Fair and Equitable in Giving the Bondholders of Union and Consumers an Interest in the Properties of Consumers and Union Respectively.

Here the bondholders of Union and the bondholders of Consumers, as well as the preferred stockholders of Consolidated, are each contributing properties to the new corporation. The bondholders of Union give up their prior right to all Union assets and, in return, share with the bondholders of Consumers prior rights to the combined assets of Union, Consumers and Consolidated. The bondholders of Consumers give up their prior right to all Consumers assets and, in return, share with the bondholders of Union prior rights to the combined assets of Union, Consumers and Consolidated. Now, the Circuit Court says that, wholly aside from the fairness of this aspect of the plan, if one bondholder objects it cannot be done.

Notwithstanding that the Circuit Court used the *Lumber Company* decision as its authority, we submit that that case in no way supports the ruling of the Circuit Court. There this Court was dealing with the right of stockholders of a hopelessly insolvent corporation to participate under the plan of reorganization without contributing anything of value. Neither the holding nor any of the language of that case lends any support to this ruling of the Circuit Court.

Section 77B and its successor, Chapter X,[1] as well as Section 77,[2] relating to railroad reorganizations, all require that a plan of reorganization, to be acceptable, must be *feasible.* It is elementary that a feasible plan cannot provide for a complicated capital structure. If the ruling of the Circuit Court is a correct interpretation of the words *fair and equitable,* it will be practically impossible to work out many reorganizations under 77, 77B and Chapter X. This is best illustrated by railroad reorganizations where there are frequently many bond issues involved.

> *Jameson v. Guaranty Trust Co. of New York,* 20 Fed. (2d) 808 (C. C. A. 7th, 1927), cert. denied 275 U. S. 569 (1927) (the plan merging two bond issues was approved by the Circuit Court);
>
> *In re Chicago & N. W. Ry. Co.,* 35 F. Supp. 230, 259 (S. C. D. Ill., 1940) (12 separate bond and debenture issues);
>
> *In re United Railways and Electric Company,* 11 F. Supp. 717 (D. C. Md., 1935) (9 separate bond and debenture issues);
>
> *Missouri Pacific Reorganizations,* 239 I. C. C. 7 (1940).

The statutory requirement that reorganization plans be feasible was wholly disregarded by the ruling of the Circuit Court, and the ruling should be reversed.

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[1]52 Stat. 883 *et seq.* (1938), 11 U.S.C.A. §502 *et seq.* (1939).

[2]47 Stat. 474 *et seq.* (1933), 11 U.S.C.A. §205 (1937).

V.

The Plan Is Fair and Equitable.

The pertinent facts as shown by the Record are as follows:

(a) VALUATION TESTIMONY.

	Mitchell	Gautier	Rogers
	[R. 281-2]	[R. 290]	[R. 292]
Union	$1,975,200	$1,750,000	$2,318,000
Consumers	1,267,100	1,436,000	750,000
Reliance	175,000	190,000	200,000
Consolidated	500,000	534,000	(Did not testify)
[1]Total	$3,917,300	$3,910,000	$3,268,000

(b) PRINCIPAL AND ACCRUED INTEREST ON BONDS.

Principal amount of Union bonds	$1,877,000
Accrued and unpaid interest to April 1, 1937 [R. 191][2]	402,555
Principal amount of Consumers bonds	1,137,000
Accrued and unpaid interest to April 1, 1937 [R. 192][2]	221,715
Total	$3,639,270

[1]The foregoing values are values of the operating properties and do not include either current assets of Consolidated or value of the goodwill of Consolidated as a going concern. Mr. Mitchell testified that in his opinion the value of that goodwill was $500,000.

[2]The Plan provides that the new bonds shall be dated and bear interest as of April 1, 1937.

(c) Equity of Consolidated Preferred Stockholders.

	Mitchell's Testimony	Gautier's Testimony	Rogers' Testimony
Value of operating properties[1]	$3,917,300.00	$3,910,000.00	$3,768,000.00
Net current assets as of September 30, 1937 [R. 282]	342,784.01	342,784.01	342,784.01
Total assets (excluding good will)	4,260,084.01	4,252,784.01	4,110,784.01
Less total bonded debt as of April 1, 1937 [R. 189-192][2]	3,639,270.00	3,639,270.00	3,639,270.00
Stockholders' equity	620,814.01	613,514.01	471,514.01
Good will[3]	500,000.00	500,000.00	500,000.00
Stockholders' equity, including good will	$1,120,814.01	$1,113,514.01	$971,514.01

Obviously, the enterprise as a whole is solvent. Both the Master and the District Court so found. [R. 153, 245.] If we use the highest figures given for Consumers and for Union, each of them is solvent. The Trial Court

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[1]Inasmuch as Mr. Rogers did not testify to the value of the Consolidated properties, the lower of the two valuations given to these properties by Messrs. Mitchell and Gautier has been included in this figure.

[2]The plan is effective as of April 1, 1937.

[3]Messrs. Gautier and Rogers did not testify as to goodwill, and therefore the value of this item given by Mr. Mitchell has been included for the purposes of comparison.

could have done this. It apparently used average figures and found those two subsidiaries insolvent when considering only the assets admittedly subject to the liens of their respective indentures.

The true situation can be shown most clearly by setting forth separately the facts and figures first, accepting the petitioners' contentions as correct and second, accepting the respondent's contentions as correct. They are as follows:

Example I. Assuming Petitioners' Position to Be Correct.

It has been shown already, *supra*, pages 14-16, that any rights under the operating agreement which may be reached by the bondholders must be determined by the agreement as modified in 1933. Accepting this, the situation then should be as follows:

(1) Consumers and Union are insolvent on the basis of the assets admittedly subject to their respective liens. (If the Trial Court had seen fit to use the highest appraisals, these corporations would have been solvent. Gautier Appraisal as to Consumers. [R. 290]; Rogers Appraisal as to Union and Reliance. [R. 292.])

(2) There is no *present* claim by either Union or Consumers against Consolidated. (No claim exists until the termination of the operating agreement and it ran until February 16, 1938, with an option in Consolidated to extend it for an additional five years. [R. 180-181.])

(3) Consumers and Union bondholders will have to establish their deficiency against Consumers and Union by foreclosure and a subsequent appraisal under California law. The bondholders cannot reach any claim under the operating agreement directly, for the operating agreement is not for the benefit of third parties.

(4) Foreclosure will require segregation of properties. This means a three-cornered fight between Union, Consumers and Consolidated. It also means heavy expense and the wrecking of the enterprise as a going concern.

(5) Consumers and Union will have to terminate the operating agreement in accordance with its terms.

(6) Appraisers will have to be appointed and make their report before the amount of the claim can be determined. This determination will take a substantial amount of time and involve considerable expense.

(7) Once the claim is determined, neither Consolidated nor Union can reach the *assets* of Consolidated. Consolidated is given the option of paying the claim in ten yearly installments and the assets cannot be reached unless there is a default by Consolidated under that agreement.

Consolidated is contributing assets valued, using averages of the valuation testimony, at over $1,359,000 as against the contribution of the operating companies totaling approximately $3,354,000. The assets being contributed by Consolidated are, under the present valuation figures, subject at most to a claim in favor of the bondholders amounting to approximately $290,000. Before the bondholders can establish any rights under this claim they

must have a foreclosure sale and an appraisal to establish the value of the properties subject to the bond indentures. If such properties are appraised at or above $3,639,270.00, the bondholders will have no rights directly or indirectly under the operating agreement. Even if such a right is established in favor of the bondholders, it is only a right, the payment of which may be deferred for the most part until 1953.

While contributing approximately 22% of the assets of the combined enterprise, the preferred stockholders retain the right to elect only five out of nine directors and accept a junior position respecting both income and principal. If anything seems apparent, it is that any unfairness is to the disadvantage of the preferred stockholders and not of the bondholders.

Example II. Assuming Respondent's Position to Be Correct.

Even if we assume that the agreement of 1933 is void and that the original agreement is in full force and effect, the position is not very materially altered. On this assumption we have the following situation.

Union and Consumers will be solvent because to their assets will be added their claim against Consolidated, thereby adding $1,359,784, or, if goodwill is omitted, $859,784. If this is added to each company in the proportion indicated on the balance sheet [R. 317, 319] Union's assets will be increased roughly $806,352 with goodwill, and $509,852 without, while Consumers would be increased

$553,432 and $349,932 respectively.. Now, if we recalculate the value of the assets of Union and Consumers on that basis, and deduct bond principal and interest from each, we find the following result:

Union		Consumers	
Union assets (average of appraisals)	$2,202,733	Consumers assets (average of appraisals)	$1,151,033
Proportion of tangible assets of Consolidated	509,852	Proportion of tangible assets of Consolidated	349,932
Total	$2,712,585	Total	$1,500.965
Principal and accrued interest to Apr. 1, 1937, Union Bonds	2,279,555	Principal and accrued interest to Apr. 1, 1937, Consumers bonds	1,358,715
Equity on tangible assets	$ 433,030	Equity on tangible assets	$ 142,250
Add proportion of good will (60% of $500,000)	300,000	Add proportion of good will (40% of $500,000)	200,000
Overall equity	$ 733,030	Overall equity	$ 342,250

The preferred stockholders are still contributing approximately 22% of the assets of the combined enterprise while they retain the right to elect only 5 out of 9 directors and accept a junior position respecting both income and principal. How can it fairly be said that such a plan unduly favors the preferred stockholders to the detriment of the bondholders?

The foregoing discussion of this case and examples demonstrate three things: First, the highly complicated problem with which the District Court had to deal; second, the futility of and lack of need for any so-called independent appraisal; and third, that the treatment afforded to the bondholders is very fair considering their contribution to the new enterprise.

The interested parties who conscientiously struggled with this problem for years realized the almost hopeless problem of arriving at a plan which would meet with the requisite approval. It must be borne in mind that two-thirds of the Consumers' bondholders, at one time confident of upsetting the operating agreement, proposed and approved a plan of reorganization separate and apart from Consolidated and Union. [R. 269-70.] Both the Union bondholders' Committee and the Consumers' bondholders' Committee had as able counsel as is available on the question of the enforceability of the operating agreement and the effect of the modification thereof. Despite this move on the part of the Consumers' Committee and the study of the validity of the operating agreement and its modification by counsel for both Committees, both groups approved the plan now before this Court. Now its consummation has been placed in jeopardy, not by an interested party who has tried to aid in the solution, but by one who acquired his bonds just before and just after the institution of these proceedings at an average cost of fifteen cents on the dollar. Now, this lone objector, setting himself up as the Guardian Angel of the bondholders who, he says, could not themselves *afford* to attack the plan, seeks to upset it and force the parties to resort to expensive and futile ap-

praisals as well as expensive and time-consuming litigation of doubtful value, though he has never affirmatively taken a constructive part in the formulation of any plan. It is indeed a strange cloak for respondent. Does he close his eyes to the fact that there were individuals holding blocks of bonds in amounts from $10,000 to $30,000, who consented to the plan? [R. 296.] Does he close his eyes to the fact that the Consumers' bondholders at one time approved a separate plan of reorganization but thereafter approved this plan? Does he really believe that this plan would not have been fought by these people if they had felt it inequitable and unfair? His charitable garments do not fit, and his angelic guise is a bit incongruous.

Respondent has taken the position that the preferred stockholders get too much. Does he forget that *these people* were not speculators; that when they bought their stock there were no liens or claims ahead of them, and that their stock called for but a 6% return, the same rate as his bonds. Does he forget that while the preferred stockholders have received only five quarterly dividends since their investment of $7,000,000 in 1929 [R. 246], the bondholders have received their interest payments until March and July 1934, and their sinking fund requirements until September 1933 and July 1934? [R. 191-193.] Does he forget that continued separate operation of Union and Consumers would have resulted in hopeless default much sooner than was the case under the unified operation made possible by the preferred stockholders? [R. 305-311.] Furthermore, can it be said that this plan is, by any stretch of the imagination, unfair to this respondent?

The trial court was familiar with all of these factors and the host of problems involved in this reorganization. Its judgment should stand.

Conclusion.

The decision of the Circuit Court of Appeals erroneously overruled reasonable and fair determinations of the District Court. The Circuit Court of Appeals misconstrued the *fair and equitable* standard in ruling that the preferred stockholders cannot be given an interest in the properties of Union and Consumers as provided by the plan. The Circuit Court of Appeals misconstrued the *fair and equitable* standard in ruling that the plan could not, over a lone bondholder's objection, give to each of the two groups of bondholders an interest in the property of the other. The Circuit Court erred in failing and refusing to confirm the decree of the District Court on the ground that the plan is *unfair and inequitable*. Therefore, we respectfully urge that this Court reverse the Circuit Court of Appeals in all respects and reinstate the decree of the District Court approving the plan.

Respectfully submitted,

PAUL R. WATKINS,

DANA LATHAM,

Attorneys for Petitioners.

APPENDIX.

APPENDIX I

Fact Comparison of Present Case

Los Angeles Lumber Products Co.*

I. Securities affected by the plan:

(a) $3,800,000 principal and interest fi[rst mort]gage bonds.

(b) 57,000 shares of Class A Common

(c) 5,000 shares of Class B Common S

II. Value of enterprise and solvency:

(a) Value of all properties of debtor $ par value of bonded debt, $3,800,00 court finds that liquidation at fu concern value will pay the bondho 25% of their claim.) (Decision pa 119.)

(b) The debtor is found to be insolven the equity and in the bankruptc (This court characterizes it as "I insolvent.") (Decision page 124)

III. Justification for the 23% participation of stock.

(a) A contract between the intereste antedating the 77b proceedings and foreclosure provided for the plan of zation.

(b) Avoidance of expense and damage closure.

*These facts and figures are taken from this Court's Lumber Products case (*supra.*)

lidated Rock Products and Subsidiaries*

Securities affected by the plan:

nsolidated	Union	Consumers
shs. pfd. stock shs. com. stock creditors)	Common Stock (No. of shares immaterial) Bonds—1,970,000 (No other creditors)	Common stock (No. of shares immaterial) Bonds—1,200,000 (No other creditors)

Value of enterprise and solvency:

nsolidated	Union	Consumers
ue—),000 exclusive good will and e name. [R. 2.]	$2,200,000	$1,150,000
nded Debt— bonded debt	$2,330,000 (Principal and accrued interest)	$1,390,000 (Principal and accrued interest)

ency—
on and Consumers insolvent; Consolidated enterprise solvent.
245.]

Justification of participation by preferred stockholders of *Consolidated:*

(a) Even assuming that the bondholders can reach assets of Consolidated the enterprise is solvent by $480,000 (summary above).

(b) If the bondholders cannot reach the assets of Consolidated its preferred stockholders contributed $850,000.00 plus good will and trade name valued at $500,000:00. [R. 281-2.]

ss otherwise designated these figures are from the Circuit
Opinion dated November 4, 1939.

Los Angeles Lumber Products Co.* (cont'd).

(c) Maintenance of a going concern.

(d) Stockholders had financial standing an fluence beneficial to corporation.

IV. Financial structure under the plan:

(a) 640,000 shares of $1.00 par value stock the bondholders).

(b) 188,000 shares of $1.00 par value com stock (to the Class A stockholders wi subscription or assessment).

*These facts and figures are taken from this Court's decis *Lumber Products* case, (*supra.*)

lidated Rock Products and Subsidiaries* (cont'd).

(c) In order to reach Consolidated's assets each bondholder group must foreclose its lien, establish a deficiency, if any, then succeed in a favorable construction of the operating agreement and the voiding of the modification of the operating agreement.

(d) Consolidated's preferred stockholders contributed more than $7,000,000 to the enterprise, acquired preferred stock subject to no prior lien and should not, under the circumstances, be entirely eliminated.

Financial structure under the plan:

(a) All the assets of all the companies in one new company.

(b) $1,507,000 par value new bonds (this represents one-half of present bonds).

(c) $1,507,000 par value preferred stock (30,140 shares at $50 per share). (This represents one-half of the present bonds.)

(d) 285,000 shares of common stock ($2.00 par value). (To present preferred stockholders of Consolidated.)

(e) Additional shares of common stock to be converted through warrants.

s otherwise designated these figures are from the Circuit Opinion dated November 4, 1939.

Los Angeles Lumber Products Co.* (cont'd).

V. Effect on securities affected by the plan:

(a) Bonds—converted into preferred stock ing a par value of $640,000 (roughly of the par value of the cancelled bonds interest thereon).

(b) Stock—Class B stock eliminated (this sented old interest on bonds). Class A obtains 23% of the assets and voting p

*These facts and figures are taken from this Court's dec *Lumber Products* case (*supra.*)

lated Rock Products and Subsidiaries* (cont'd).

Effect on securities affected by the plan:

(a) Bonds—

1. Full principal converted into one-half bonds and one-half preferred stock against all assets of all companies.

2. Cancels accrued interest in the amount of $625,000.00.

3. Changes interest rate from 6% to 5% and makes it cumulative on the new bonds and non-cumulative on new preferred stock.

4. Eases default provisions but gives bondholders management control on default.

5. Provides for common stock warrants.

(b) Stock of Union and Consumers—eliminated.

(c) Common stock of Consolidated—eliminated except for warrant rights.

(d) Preferred stockholders of Consolidated—

1. Surrenders for cancellation $166,000 par value of bonds of Union and Consumers.

2. Obtains common stock of new company share for share.

3. Becomes subject to prior lien of new bonds and prior claim of new preferred stock.

otherwise designated these figures are from the Circuit pinion dated November / 1939.

Tightly Bound

APPENDIX II

California Code of Civil Procedure

§ 726. **Recovery of debt or enforcement of right secured by mortgage: Proceedings in foreclosure suits.** There can be but one form of action for the recovery of any debt, or the enforcement of any right secured by mortgage upon real or personal property, which action must be in accordance with the provisions of this chapter. In such action the court may, by its judgment, direct the sale of the encumbered property (or so much thereof as may be necessary), and the application of the proceeds of the sale to the payment of the costs of court, and the expenses of the sale, and the amount due plaintiff, including where the mortgage provides for the payment of attorney's fees, such sum for such fees as the court shall find reasonable, not exceeding the amount named in the mortgage.

Commissioner, appointment, compensation and oath. The court may, by its judgment, or at any time after judgment, appoint a commissioner to sell the encumbered property. It must require of him an undertaking in an amount fixed by the court, with sufficient sureties, to be approved by the judge, to the effect that the commissioner will faithfully perform the duties of his office according to law. Before entering upon the discharge of his duties he must file such undertaking, so approved, together with his oath that he will faithfully perform the duties of his office.

Decree, matters to be declared and determined: Deficiency proceedings: Appraiser. The decree for the foreclosure of a mortgage or deed of trust secured by real property or any interest therein shall declare the amount of the indebtedness or right so secured and, unless judg-

ment for any deficiency there may be between the sale price and the amount due with cost is waived by the judgment creditor, shall determine the personal liability of any defendant for the payment of the debt secured by such mortgage or deed of trust and shall name such defendants against whom a deficiency judgment may be ordered following the proceedings hereinafter prescribed. In the event of such waiver the decree shall so declare and there shall be no judgment for a deficiency. In the event that a deficiency is not waived and it is decreed that any defendant is personally liable for such debt, then upon application of the plaintiff filed at any time within three months of the date of the foreclosure sale and after a hearing thereon at which the court shall take evidence and at which hearing either party may present evidence as to the fair value of the property or the interest therein sold as of the date of sale, the court shall render a money judgment against such defendant or defendants for the amount by which the amount of the indebtedness with interest and costs of sale and of action exceeds the fair value of the property or interest therein sold as of the date of sale; provided, however, that in no event shall the amount of said judgment, exclusive of interest from the date of sale and of costs, exceed the difference between the amount for which the property was sold and the entire amount of the indebtedness secured by said mortgage or deed of trust. Notice of such hearing must be served upon all defendants who have appeared in the action and against whom a deficiency judgment is sought, or upon their attorneys of record, at least fifteen days before the date set for such hearing. Upon application of any party made at least ten days before the date set for such hearing the court shall,

and upon its own motion the court at any time may appoint one of the inheritance tax appraisers provided for by law to appraise the property or the interest therein sold as of the time of sale. Such appraiser shall file his appraisal with the clerk and the same shall be admissible in evidence. Such appraiser shall take and subscribe an oath to be attached to the appraisal that he has truly, honestly and impartially appraised the property to the best of his knowaledge and ability. Any appraiser so appointed may be called and examined as a witness by any party or by the court itself. The court must fix the compensation, not to exceed $5 per day, and expenses for the time actually engaged in such appraisal, which may be taxed and allowed in like manner as other costs.

Unrecorded claim. No person holding a conveyance from or under the mortgagor of the property mortgaged, or having a lien thereon, which conveyance or lien does not appear of record in the proper office at the time of the commencement of the action need be made a party to such action, and the judgment therein rendered, and the proceedings therein had, are as conclusive against the party holding such unrecorded conveyance or lien as if he had been a party to the action.

Sale by commissioner. If the court appoint a commissioner for the sale of the property, he must sell it in the manner provided by law for the sale of like property by the sheriff upon execution; and the provisions of Chapter I, Title IX, Part II, of this code are hereby made applicable to sale made by such commissioner, and the powers therein given and the duties therein imposed on sheriffs are extended to such commissioner.

Death, etc., of commissioner: Appointment of elisor, etc. In all cases heretofore, now or hereafter pending in the courts of this State, in the event of the death, absence from the State, other disability or disqualification of the commissioner appointed to sell encumbered property under the foregoing provisions of this section, the court may, upon the happening of either the death, absence from the State, other disability or disqualification of the commissioner, appoint an elisor to perform the duties of such commissioner which are then to be performed in such action. The elisor so appointed shall give the undertaking, and take the oath hereinbefore provided to be given and taken by a commissioner, before entering upon the discharge of his duties, and shall thereafter perform all duties left unperformed by the commissioner whom he is appointed to succeed, with like effect as if such duties had been performed by the commissioner.

Property in two or more counties. If the land mortgaged consists of a single parcel, or two or more contiguous parcels, situated in two or more counties, the court may, in its judgment, direct the whole thereof to be sold in one of such counties by the sheriff, commissioner or elisor, as the case may be, and upon such proceedings, and with like effect, as if the whole of the property were situated in that county. [Enacted 1872; Amended by Stats. 1893, p. 118; Stats. 1895, p. 98; Stats. 1901, p. 48; Stats. 1933, p. 2118; Stats. 1937, chap. 353.]

REPLY BRIEF FOR PETITIONERS

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IN THE

Supreme Court of the United States

October Term, 1940

No. 400.

In the Matter of

CONSOLIDATED ROCK PRODUCTS CO., a Delaware corporation,

Debtor,

UNION ROCK COMPANY, a corporation,

Subsidiary,

and

CONSUMERS ROCK & GRAVEL COMPANY, INC., a corporation,

Subsidiary.

CONSOLIDATED ROCK PRODUCTS CO., a corporation, and EDWARD E. HATCH and LOUIS VAN GELDER, composing the Preferred Stockholders Committee of Consolidated Rock Products Co.,

Petitioners,

vs.

E. BLOIS du BOIS,

Respondent.

REPLY BRIEF FOR PETITIONERS.

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Attorneys for Petitioners.

Parker & Baird Company, Law Printers, Los Angeles.

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SUBJECT INDEX.

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Respondent.

REPLY BRIEF FOR PETITIONERS.

Introductory.

The respondent and the S.E.C. in their briefs set forth several contentions, some in answer to matters contained in our opening brief and some involving new matters, to which we wish to reply. Summarized our reply is as follows:

THE DISPUTED CLAIM ARISING OUT OF THE OPERATING AGREEMENT.

1. The Disputed Claim Was Compromised.

2. On Its Merits the Compromise Should Have Been Approved by the Circuit Court.

   a. There is no net current account existing in favor of Union and Consumers.

   b. The fact that Consolidated could properly defer payment of amounts due under the operating agreement is very important.

   c. Any alternative to the compromise will involve foreclosure proceedings.

VALUATION.

1. The Present Findings of Value Are Clearly Adequate.

WARRANTS TO COMMON STOCKHOLDERS.

1. The Plan is Not Unfair in Giving Stock Purchase Warrants to the Present Common Stockholders.

ALLEGED DISCRIMINATION AGAINST UNION BONDHOLDERS IN FAVOR OF CONSUMERS BONDHOLDERS:

1. The Plan Does Not Unfairly Discriminate Against Union Bondholders in Favor of Consumers Bondholders.

DISREGARD OF SEPARATE CORPORATE ENTITIES.

1. To Disregard Separate Corporate Entities in the Present Case Would Be Grossly Unfair to Consolidated Preferred Stockholders.

STATUS OF RESPONDENT.

The Disputed Claim Arising Out of the Operating Agreement.

1. The Disputed Claim Was Compromised.

In our first specification of error we contended that the disputed claim had been compromised and that the Circuit Court erred in refusing to approve the compromise. (Br. pp. 10-17.)

In answer to this contention both respondent and the S.E.C. assert that there never was a compromise of the claim. (Resp. Br. p. 17; S.E.C. Br. pp. 40-41.) The record shows that the representatives of both groups of bondholders were at all times fully aware of the rights under the operating agreement. [R. 275-6, 278.] The record shows further that the parties fought over a plan of reorganization for almost two years before one was worked out which was acceptable to all interested groups. The Special Master expressly found that the plan took into consideration all of the claims, equities and rights of the bondholders and stockholders. [R. 159.] In the light of these facts it is clear that the plan embodies a compromise of these claims on a basis which the interested groups felt was fair and in the best interests of all. The respondent and the S.E.C. rely heavily upon the fact that the compromise was not spelled out in the plan. (Resp. Br. p. 17; S.E.C. Br. pp. 40-41.) In this connection it should be noted that the most controverted issue, the application of income to service the new bonds, which issue was compromised, was not spelled out in the plan. Certainly it cannot and is not contended that that controversy was not compromised. The contention that the disputed claim was not compromised is without merit.

2. On Its Merits the Compromise Should Have Been Approved by the Circuit Court.

In support of this first specification of error that the Circuit Court erred in refusing to sanction the compromise of the disputed claim arising out of the operating agreement, we pointed out that any rights of Union and Consumers arising out of the operating agreement were rights the discharge of which by the terms of the modified operating agreement Consolidated was entitled to defer for the most part until 1953. (Br. pp. 12-16.) We pointed out further that before the bondholders could have established in the bankruptcy proceedings their right to any claim of their corporation against Consolidated, a cumbersome, expensive and time-consuming proceedure would have to be followed and that this fact was an additional reason why the compromise, reached by the parties bargaining at arm's length, should not have been disapproved. (Br. pp. 16-17.)

On the merits of the compromise both the respondent and the S.E.C. assert that it is immaterial that Consolidated may properly defer payment of any claims due under the operating agreement for the most part until 1952. (Resp. Br. pp. 18-19; S.E.C. Br. pp. 38-39.) The S.E.C., referring to some June 30, 1938, balance sheets of Consolidated, Union and Consumers, further asserts that there are current accounts payable totaling over $250,000 due by Consolidated to Union and Consumers and that these amounts together with rights under the operating agreement entitle the bondholders to be made whole and accordingly the plan is unfair where they are not given securities for accrued interest.

a. There Is No Net Current Account Existing in Favor of Union and Consumers.

With regard to the alleged net current amounts payable in favor of Union and Consumers the contention of the S.E.C. is wholly erroneous. By Section 7 of the operating agreement [R. 167-8] Consolidated agreed to pay Union and Consumers amounts sufficient to pay interest on outstanding bonds. The accounting procedure followed was for Consolidated to credit the subsidiaries' current accounts monthly for the bond interest due and the allocable portion of the bond discount and expense, and when payment of the interest was made, to charge their current accounts with the interest paid. Since April 1, 1937, the effective date of the present plan, Consolidated has continued to credit the subsidiaries' current accounts with bond interest and the allocable portion of the bond discount and expense. This practice is reflected by the Consolidated income statement [R. 315] showing that these items were on June 30, 1938, still being accounted for on Consolidated's books. During the periods, April 1, 1937-June 30, 1938, Consolidated has credited the current accounts with 15 x $15,116.67 or $226,750.05 for interest and 15 x $1,192.00 or $17,880.00 for the bond discount and expense, or a total of $244,630.05 for these items. The June 30, 1938, balance sheet of Consolidated [R. 316] shows a net account payable due upon termination of the operating agreement amounting to $256,598.56. Why does the S.E.C. use June 30, 1938?. Why didn't it calculate the balance, as above, as of April 1, 1937, the effective date of the plan? That date is the only date which can be fairly used. Any credits by Consolidated to the current accounts for interest and bond discount and expense made after April 1, 1937, cannot, for the purposes

of this proceeding be considered as current amounts presently due to Union and Consumers. Even if we assume that the operating agreement was terminated in 1938 as the S.E.C. contends we must,[1] these subsequent credits still could not be considered here.

b. *The Fact That Consolidated Could Properly Defer Payment of Amounts Due Under the Operating Agreement Is Very Important.*

Both the respondent and the S.E.C. assert that it is of no consequence that the claim against Consolidated is one payment of which Consolidated could properly defer for the most part until 1953. (Resp. Br. pp. 18-19; S.E.C. Br. pp. 39-39.) They both assert that if the bondholders can prove that their claim exists, they are entitled to be made whole, regardless of the fact that such rights are not present rights but are for the most part rights maturing in 1953. The same premise is used by both the respondent and the S.E.C. elsewhere in their briefs as the basis for arguing that the plan is not fair and equitable because the bondholders are not fully compensated. Certainly it will not be doubted that the fundamental purpose of Section 77B is to preserve to all parties the value of their interests in the enterprise. As of the effective date of this plan, April 1, 1937, Consolidated owned assets having a value of approximately $1,359,000 which it could by the terms of the operating agreement operate

[1]The S.E.C. contends that the operating agreement must be considered as having terminated in 1938 since the Record fails to disclose notice by Consolidated of intent to renew. (S.E.C. Br. p. 37.) We respectfully submit that since the crucial date here is April 1, 1937 this contention is irrelevant, and further that the contention is erroneous in that the record fails to show that the agreement was terminated, but rather, it shows clearly that the enterprise is being operated just as it was prior to the commencement of the present proceedings.

until 1953 free, for the most part, of any claims of Union or Consumers arising out of the operating agreement. (Br. p. 29.) To treat this situation, as the respondent and the S.E.C. do, the same as one where Consolidated owned these properties subject to a presently due claim in favor of Union and Consumers evidenced by presently due promissory notes rather than by promissory notes due several years hence and where Consolidated would be under an immediate obligation to sacrifice the assets to meet such claim is to absolutely disregard the factual difference between the two situations as well as to disregard the purpose of Section 77B to preserve to all groups the value of their respective interests. Their contention assumes fallaciously that one with assets which he may operate for a long period, paying off a claim at the end of that period, is in the same position as one with assets that must immediately be sacrificed for payment of a presently due claim. A recognition of the difference in the two situations when applied to the facts of the present case refutes this contention of the respondent and of the S.E.C. that the preferred stockholders are not entitled to share under the plan until the bondholders are fully compensated. The bondholders do not have a present right to assets equal to or in excess of their bond principal plus accrued interest. Accordingly, it is not necessary that they be fully compensated before the preferred stockholders be allowed to participate in the plan.

The true picture is then as we have set it forth in our opening brief. (Br. pp. 26-33.) Consolidated contribut-

ing substantial assets; Union and Consumers contributing a larger portion of the assets; all assets going into a new enterprise; the question being, have all parties been given interests in the new single enterprise, commensurate with their separate contributions? We submit that the answer is in the affirmative.

c. *Any Alternative to the Compromise Will Involve Foreclosure Proceedings.*

In support of the plan's compromise of the disputed claim, as noted above, we pointed out that any alternative steps taken with a view to determining the rights of the bondholders against Consolidated would require an expensive time-consuming and cumbersome foreclosure procedure. (Br. pp. 6-17.) This fact was not set forth to suggest the use of obstructive tactics by any group, but merely to show correctly the alternatives open to the interested parties. The respondent answers that this procedure may be eliminated by a sale of the properties of Union and Consumers by the respective indenture trustees. (Resp. Br. pp. 19-20.) However, there is nothing in the record that even suggests that the indenture trustees have a power of sale.

The S.E.C. answers that no foreclosure proceedings are necessary but that the bondholders could waive their security and assert an unsecured claim against Union and Consumers, respectively, for the full amount of the bonds plus accrued interest. This we submit is erroneous. Before the bondholders could assert any unsecured claim against

Union and Consumers, respectively, it would be necessary that they have such a valid enforceable claim under California law for such amount.

2 Gerdes on Corporation Reorganization (1st Ed., 1936), Sec. 883;

2 Remington on Bankruptcy (4th Ed., 1915), Sec. 955.

By California law the indenture trustees for these mortgagees can enforce the rights growing out of the debts secured by a mortgagee only by following the procedure set forth in Code of Civil Procedure, Section 726 (Br., Appendix II.) This statute was enacted for the very purpose of avoiding the result suggested by the S.E.C. It was enacted to insure mortgagors that they should first have their obligations discharged to the full and fair value of the security before the mortgagee could assert any deficiency claim. It is not a question of obstructive tactics. It is merely a fact that the procedure there set forth must be complied with before the bondholders can assert a right, valid and enforceable under California law, to any claim existing in favor of Union and Consumers against Consolidated. The avoidance of such a procedure which would bring about the wrecking of the entire enterprise is another reason why the compromise should be approved and why the parties should not be forced to litigate this disputed claim.

Valuation.

1. The Present Findings of Value Are Clearly Adequate.

The plan here involved is based upon valuations determined from testimony of experts who have worked with the properties in question for years. (Br. pp. 19-20.) There is no one in a position to know the values of the properties as well as these witnesses. Yet the S.E.C. contends that the evidence does not warrant proper findings of value because there is insufficient evidence as to earnings. The S.E.C. would substitute for the judgment of these extremely well qualified witnesses some hypothetical future earnings record which would at most be a guess based upon the prior operations during the greatest depression period in modern history and upon the past physical makeup of the enterprise which physical makeup will be tremendously improved by the liquidations of unneeded property as anticipated under the present plan. On these facts such a guess as to future earnings would be quite inadequate as a criterion of value.

Warrants to the Common Stockholders.

1. The Plan Is Not Unfair in Giving Stock Purchase Warrants to the Present Common Stockholders.

Both the respondent and the S.E.C. assert that the plan is unfair because the common stockholders are given stock purchase warrants whereas it has been found that they have no equity. (Resp. Br. pp. 34-35; S.E.C. Br. pp. 33-34.) This assertion is based upon the assumption that these warrants have some value. The warrants

will entitle the old common stockholders to purchase, within three months of the date of the warrants, 1/5th of a share of new common stock for each share of old common held, at a price of $1.00 per share of new common. Whether these warrants will or will not have any value is entirely problematical. When the plan was devised all interested parties felt that it was highly advisable to obtain badly needed cash by this method to defray the costs of reorganization. The bondholders were given warrants exercisable over a long period of time in an effort to allow them to participate in the equity if the reorganized enterprise proved highly successful. In any event the old common stockholders can only come in by furnishing new capital. Since their warrants expire in three months and since the early months of the enterprise are bound to be uncertain, it is not unfair to give such warrants to the old common stockholders when, as is done here, the bondholders are given warrants, exercisable over a much longer period, even though at a higher price. In the *Lumber Products* case this court recognized that there are times when it may be proper for the common stockholders to be given stock purchase warrants even though they have no equity.[1] We respectfully submit that the warrants to be issued to the old common stockholders in this case does not render the plan unfair toward the objecting bondholders who receive warrants exercisable up to within 5 years from their date.

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[1]*Case v. Los Angeles Lumber Products Co. Limited,* 308 U. S. 106, 117 (1939).

Alleged Discrimination Against Union Bondholders in Favor of Consumers Bondholders.

1. The Plan Does Not Unfairly Discriminate Against Union Bondholders in Favor of Consumers Bondholders.

Respondent asserts in his brief that the plan is unfair in that it provides that the income shall be used equally to service the bonds and preferred stock of the present Union bondholders and to service the bonds and preferred stock of the present Consumers bondholders. (Resp. Br. pp. 39-42.) He points out that the present Union bondholders are contributing more assets to the new enterprise than are the present Consumers bondholders and that therefore more than half of the income should be applied to servicing the bonds and preferred stock of the present Union bondholders. The respondent omits to point out that the question of the application of income to servicing the new securities was only one of three major points of dissension encountered in formulating a plan acceptable to both the Union Committee and the Consumers Committee and that the solution reached on this point is only part of a general compromise of all three major points [R. 68-70, 84-86]. This omission itself makes the objection here lose any merit it might otherwise have. Further, this lone objector seeks to have this court substitute his judgment for the judgment of the District Court, of the Special Master and of the Committees who arrived at the present plan only after almost two years of bitter controversies. This we submit should not be done.

Disregard of Separate Corporate Entities.

1. TO DISREGARD SEPARATE CORPORATE ENTITIES IN THE PRESENT CASE WOULD BE GROSSLY UNFAIR TO CONSOLIDATED PREFERRED STOCKHOLDERS.

The S.E.C. has suggested that because the assets of Union, Consumers and Consolidated have been commingled by Consolidated in conducting unified operations of the operating properties, this Court should disregard the corporate entities and add all properties of Consolidated to the properties of Union and Consumers, treating all as securing the claims of the bondholders. This suggestion overlooks the fact that since the execution of the operating agreement in 1929 Consolidated has applied all net income with the exception of five quarterly dividends [R. 240] to the satisfaction of bond interest, retirement and sinking-fund requirements. It overlooks the fact that notwithstanding that during the depression beginning in 1929 the combined volume of operations was reduced, because of the influx of ruthless competition into the industry, from 75% of the business done in Southern California to approximately one-third of such business [R. 142, 238], the enterprise, by reason of unified operations possible only through the investment by the preferred stockholders of approximately $7,000,000 was able to stave off defaults of bond interest and sinking-fund and retirement requirements until late 1933 and early 1934. In the light of the benefits to the bondholders which have been derived from unified operations made possible only by the preferred stockholders' investments, it would hardly be equitable to follow this novel suggestion of the S.E.C.

Status of Respondent.

In our opening brief we have contended that this court should consider the facts that this lone objector purchased his bonds immediately prior and subsequent to the commencement of the present 77B proceedings at an average price of approximately fifteen cents on the dollar, and that he has at all times occupied the position of an objector refusing to act reasonably in trying to work out a fair plan acceptable to all concerned. The record discloses, and there actually was no constructive suggestion by respondent during the entire proceeding. [Br. pp. 32-33; R. 156-158, 196-206, 246-256.] Respondent answers that such matters deserve no consideration by this court.

In a recent study published by the S.E.C. under date of September 30, 1940, and which has come to our attention since filing our opening brief, the S.E.C. discusses the equitable treatment of obstructionists who have purchased their claims at bargain prices.[1] The S.E.C. concluded that in determining the voting power of claims the bankruptcy court should consider the bad faith of and the cost of the claims to the obstructionist. Only recently in the case *American United Mut. Life Ins. Co. v. City of Avon Park, Fla.*,[2] this court in citing the *In re McEwen's Laundry, Inc.* case[3] expressed its apparent approval of

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[1]Securities and Exchange Commission, Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, Part VIII, pp. 113-125.

[2]61 S. Ct. 157, 162.

[3]90 Fed. (2d) 872 (C.C.A. 6th, 1937).

such use by the bankruptcy court of its equitable powers. We submit that the same equitable principle which motivates such use of the general equity power should lead this court to weigh heavily the status of the respondent, the lone objector.

Respectfully submitted,

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